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July 24, 2002

Via Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW, Room TWB-204
Washington, DC 20554

Re: In the Matter of the Merger of Qwest Communications International, Inc. and U S West Inc., CC Docket No. 99-272

Dear Ms. Dortch:

Yesterday, Aryeh Friedman, Mark Schneider and the undersigned, all representing AT&T, met with Alex Starr, Maureen Del Duca, Mark Stone, Tony Dale, Bill Davenport, Suzanne Tetreault, Lisa Saks and Chris Olsen, all of the FCC's Enforcement Bureau. Also present at the meeting were Peter Rohrbach and Jack Keeney, representing Qwest Communications and Jonathan Marashlian, representing Touch America. Sharon Devine of Qwest Communications participated in the meeting by telephone. The purpose of the meeting was to discuss the letters and comments AT&T has filed in the above-referenced proceeding, as reflected in the record of this proceeding and the attached documents.

Consistent with Commission rules, I am filing one electronic copy of this notice and request that you place it in the record of the proceeding.

Sincerely,

Joan Marsh

cc: Maureen Del Duca
Jack Keeney
Jonathan Marashlian

Timeline

June 26, 2000: Commission Memorandum Opinion and Order approving divestiture

April 16, 2001 Arthur Anderson LLP Report of Independent Public Accountants and Qwest Certification

- 458 customers included a prohibited in-region interLATA service component code.
    - *Corporate Communications*: Qwest asserted that as to "several" of 192 customers with metered in-region interLATA services, the codes were properly assigned "because the components represented corporate communications for Qwest (which Qwest is permitted to provide to itself)" (Qwest Certification ¶ 5).
    - *Branding in-region interLATA service as Qwest:* 266 customers received in-region private line services "billed and branded as Qwest services." Associated revenues from July 2000 through March 2001 were in excess of $2.2 million. (Auditor's Report, Att. 1, at 1).

AT&T May 1, 2001 Letter Comments

- *Branding in-region interLATA service as Qwest:* AT&T argued that this constituted "providing" in-region interLATA service in violation of the Merger Order and Section 271. . *Id* at 2-4.
- *Unlawful Teaming:* AT&T provided evidence that Qwest had entered into teaming contracts with other carriers to offer in-region interLATA long distance service to federal agencies with Qwest acting as the single point of contact with Customer for ordering, billing, Service inquiry, Service Assurance and trouble reporting for the Service, and that such arrangements violated the *Merger Orders* and Section 271. *Id* at 5-7.

June 6, 2001 Letter from Arthur Anderson LLP to Ms. Dorothy Atwood, Chief, Common Carrier Bureau

- *Corporate Communications:* 11 accounts identified as corporate communications or IRUs and then noted that it is not in a position to make a legal determination regarding the matter (Finding 2).
- *IRUs:* The auditor found that Qwest was providing in-region interLATA services to 14 accounts using IRUs. The auditor stated that Qwest

believes that it is permitted to sell in-region interLATA services using IRUs, and then noted that it is not in a position to make a legal determination regarding the matter (Finding 7).

- *Branding in-region interLATA service as Qwest:* Qwest paid Touch America less than 40% of the "revenues billed" to 266 customers for Qwest-branded in-region interLATA services provided prior to March 2001 (Finding 9).

AT&T July 18, 2001 Letter Comments

- *IRUs:* Qwest is violating Section 271 and the *Qwest Merger Orders* by urging customers to use IRUs to transport their in-region interLATA traffic to a Qwest out-of-region point of presence ("POP"). *Id* at 2-3.

- *Corporate communications*: The only allowable corporate communications services would be "Official Services" and the auditor failed to verify that the 11 accounts identified as corporate communications qualified. *Id* at 4 n.10.

February 2002: Touch America Formal Complaints

March 11, 2002 Arthur Andersen Audit of Qwest

- Qwest is still holding revenues for customer traffic that Qwest had branded, billed and collected for itself, but which rightfully belongs to Touch America. Identified 657 account records as having prohibited in-region service component codes and that in-region private line services for 330 customers were "billed as Qwest services." Att. 1 at 1.

- Certain invoices during 2001 for approximately 1,000 customers who subscribe to Internet-related services did not include a separate Global Service Provider ('GSP') charge for in-region interLATA traffic carried by Touch America" (representing approximately $2 million in 2001).

AT&T April 30, 2002 Comments

- *Dependence of TA:* Qwest took steps that it concealed from the Commission to ensure that Touch America would remain dependent on Qwest in providing services to divested customers, including access to Qwest databases; using Qwest's undisclosed billing system structure to effectively requiring TA to purchase out-of-region capacity on a wholesale basis from Qwest and failing to lease to Touch America four circuit switches as represented to the Commission, instead providing Touch America with only limited functionality.

- Qwest provided in-region interLATA service and reacquired the long distances customers that it "divested" to Touch America in three ways:
    - *IRUs:* Lit fiber capacity IRUs that violated the Merger Orders and Section 271
    - *Corporate communications*: provided interLATA services to customers under the guise of "corporate communications;"
    - *Branding in-region interLATA service as Qwest:* Directly providing interLATA services "billed and *branded* as Qwest services" and retaining the revenues from such services.
- Qwest's GSP arrangement violates the Merger Order and Section 271.

Qwest/US WEST Merger Audit Proceeding Talking Points

I. Qwest Has Unlawfully Provided In-Region InterLATA Service Through IRUs:

- The Qwest lit fiber capacity IRUs are "telecommunications services" and therefore are subject to the ban in section 271 against BOC provision of in-region interLATA service

- The IRUs grant the customer only a leasehold interest, not an ownership interest, and it is well-established that leasing of capacity on an in-region interLATA network is plainly the provision of an in-region interLATA service

A. The "Qwest Lit Fiber Capacity IRUs" are nothing more than dedicated private line service agreements, which are squarely prohibited by section 271.

- Under the Qwest IRUs, Qwest controls the network used by the customer, (IRU Agreement between Qwest and Touch America, Section 6.1 (first)), provides the electronics necessary for service, (*Id.*, Sections 1.2, 2.1.) assumes the risk of service outage, (*Id.*, Section 6.2) maintains ownership of the underlying facilities, (*Id.*, Section 13.1) and even controls the path used to deliver the customer's traffic. (*Id.*, Section 2.1 read in light of Sections 1.2, 1.9 and 1.10; Qwest's Answer to the *IRU formal complaint* ¶ 84).

- "The grant of the IRU in the Qwest Capacity hereunder shall be treated for federal, state and local tax purposes as the lease of the Qwest Capacity." Section 14.2.

- Qwest used these lit fiber capacity IRUs to replace private line services provided by Touch America. *E.g.,* Teleglobe, which was receiving leased line private line service from Touch America; and Verio, which had a 15-year pre-paid private line service arrangement.

B. Qwest's arguments to the contrary completely lack merit.

- There is no merit to Qwest's claims that the "property right" transferred is the ability to choose "the type of traffic and direction . . . to transmit over the facility," that "right" accompanies *all* leased private lines services.

- Qwest's argument that it is a "sale" because "the *capacity's* estimated economic life [is] typically 20 years" is a *non-sequitor*; only assets themselves have an economic life. In contrast, the right to "[c]apacity" on network facilities over which Qwest exercises control (and, indeed, determines the path and therefore the particular facilities that will be used for any transmission) has no "economic life" because the underlying assets used to provide service can be substituted (or upgraded) at Qwest's discretion.

C. Commission and Court Precedents

1. The *Qwest Teaming Order*:

The lit fiber capacity IRUs allow Qwest "to accumulate an entrenched base of full-service customers before receiving section 271 authority, thereby undermining the incentive Congress created in section 271." This "jumpstart" on long distance services was prohibited under the scheme enacted by Congress in Section 271. *Qwest Teaming Order* ¶¶ 39, 41. Qwest is effectively holding itself out as a provider of long distance service.

2. Other Commission Precedent:

(i) Non-Accounting Safeguards Order: holds that the sale of an *entire network* does not constitute "providing" the services on that network, but that the conveyance of an interest *less* than full ownership of the entire network does constitute the provisioning of telecommunications services for the purposes of Section 271 (when "the BOCs seek to *maintain* ownership of their interLATA Official Services Networks and *lease* excess *capacity* on the networks to their affiliates," that "*leasing of capacity on an in-region interLATA network is plainly an in-region interLATA service.*"). *See also Dark Fiber Order* (rejecting claim that Commission lacked jurisdiction to regulate dark fiber as a "service" and holding that the BOCs were engaged in the provisioning of a communications service).

(ii) The Commission decisions cited by Qwest are irrelevant.

- The three involving submarine cable IRUs[1] are inapposite because they did not raise issues comparable to those relevant to a Section 271 analysis, and because the decisions were made in the context of submarine cable IRUs as used in the 1980s, that is, involving "the conveyance of circuits in submarine cables" for unlimited duration.

- The two universal service decisions are also inapposite. One[2] involves the sale of bare capacity, which is exactly the opposite of the issue presented here. In the second decision,[3] the Commission construed the term "own facilities" to include "unbundled

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[1] *Reevaluation of the Depreciated-Original-Cost Standard in Setting Prices For Conveyances of Capital Interests in Overseas Communications Facilities Between or Among U.S. Carriers,* 7 FCC Rcd. 4561, ¶ 1 n.1 (1992); Report and Order, *International Communications Policies Governing Designation of Recognized Private Operating Agencies, Grants of IRUs in International Facilities, and Assignment of Data Network Identification Codes*, 104 FCC.2d 208, ¶ 64 (1986); Report and Order, *Market Entry and Regulation of Foreign-Affiliated Entities*, 11 FCC Rcd. 3873, ¶ 130 (1995).

[2] Fourth Order on Reconsideration, *Federal-State Joint Board on Universal Service*, 13 FCC Rcd 5318, ¶ 290 (1997).

[3] First Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776 (1997), *aff'd sub nom., Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir.
(continued . . .)

network elements," but not because the competitive local exchange carrier ("CLEC") actually "owned" the unbundled network element. Rather, the Commission reasoned that it would essentially skew competition if the CLEC –having paid the ILEC the full forward-looking cost of the unbundled network element – did not receive universal service support, while the ILEC did. By contrast, Qwest is seeking here to circumvent the Act's prohibition of a BOC's participation in the long distance market until it has opened its local markets to competition, by characterizing its leased dedicated private line service as a "facility" when it is not.

3. Federal Courts:

- *Global Naps, Inc. v. New England Telephone & Telegraph*, 156 F. Supp.2d 72, 77-80 (D. Mass. 2001): federal district court, relying on the *Non-Accounting Safeguards Order* and the *Dark Fiber Order* held that "leasing of dark fiber . . . [is] the provision of telecommunications service."[4]

4. Precedents In Other Areas:

(i) *Securities/Accounting Rules*:

- Testimony Concerning Telecommunications Accounting Issues by John M. Morrissey, Deputy Chief Accountant, U.S. Securities and Exchange Commission, Before the Subcommittee on Oversight and Investigations Committee on Financial Services given on March 21, 2002 at 3: "If the [capacity IRU] does not convey to the purchaser the right to use specific identifiable assets, the contract would be viewed as an arrangement for the provision of services, and revenue would be recognized over the period of the contract as the services (the access to the network capacity) are provided."

- Arthur Andersen White Paper, Accounting by Providers of Telecommunications Network Capacity, An Update (as of February 29, 2000), at 1 (citing to a statement by an SEC official that a lit fiber capacity IRU is "nothing more than a service agreement" where there is no conveyance of rights in the conduit, fiber and electronics, and should be accounted for accordingly, *cited in Treatment of IRUs* (see (d) below) at 87, n. 13.

- *In re E.Spire Communications, Inc. Securities Litigation*, 127 F. Supp.2d 734, 747 (D. Md. 2001): held that whether an IRU was to be accounted for as a "sale" or a "service

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(. . . continued)
1999).

[4] *See, also, MCI Telecomms. Corp. v. BellSouth Telcomms., Inc.*, 7 F.Supp.2d 674, 679-80 (E.D. N.C. 1998) the district court found that dark fiber was a "telecommunication service." *Id.* at 680. *MCI Telecomms. Corp. v. Michigan Bell Tel. Co.*, 79 F.Supp.2d 768, 783-84 (D. Mich. 1999).

turned on "whether a particular IRU between the parties contained provisions resulting in a transfer of title."

(ii) ***Tax***:

- Frederick W. Quattlebaum, Ventures on the High Seas: US Federal Tax Treatment of a Sale of IRU Capacity, 1192 PLI/Corp 583 (2000) ("*PriceWaterhouseCoopers, IRU Tax Treatment*"): For federal tax law purposes whether an IRU involves a sale, lease or service, turns on a number of considerations of which duration is only one. Equally, if not more significant, are issues of ownership and control: where an IRU conveys to the service *recipient* only a right to use an assigned amount of capacity while the service *provider* is responsible for maintenance, replacement and repair, and the service provider can utilize the underlying assets to provide services to entities unrelated to the service recipient, the IRU is likely to be a service agreement.

D. Qwest's claims that the Commission approved these IRU arrangements in the *Qwest Merger Orders* is specious:

1. The *April 14 2000 Divestiture Plan*:

(i) Qwest did not disclose any intent to enter into the types of IRUs Qwest entered into with TA and others. The only IRUs described in the Divestiture Plan:

- Past sales that it could not unwind (in a footnote identifying a *single* transaction, Project Abilene, involving the UCAID – University Corporation for Advanced Internet Development – IRU); and

- As to future sales, after quoting from the *Non-Accounting Safeguards Order* regarding IRUs that involved "the one time transfer of ownership and control of an interLATA network" stated that it "intends to continue selling *similar* telecommunications services."

(ii) AT&T specifically addressed the UCAID IRU in its discussion of the proposed joint provisioning of Internet service, noting that to the extent the UCAID IRUs involved Qwest in providing in-region, InterLATA Internet Backbone service, they would violate Section 271. The Commission approved this portion of the Merger because. "Qwest states that 'at divestiture it would discontinue the provision of any prohibited in-region interLATA backbone service crossing U S WEST LATA boundaries.'" (Paragraph 37).

With respect to Qwest serving as an Internet service provider (ISP), the Commission noted that Qwest represented to it that it:

> "will hand its traffic off to the GSP. The GSP will carry the traffic across in-region LATA boundaries and then out-of-region to the Internet using its own network or "via its arrangements with other [Internet] backbone providers." Neither GSP will direct traffic to a Qwest router out-of-region. ... We note that Qwest states that in the future, it may "provide Internet service to in-region customers on a different, but legally permissible, basis from the arrangements that will apply at divestiture." If Qwest does decide to

change these arrangements we require that it notify the Chief of the Common Carrier Bureau prior to making such a change."

(Paragraph 38).

2. The March 29, 2000 *ex parte* meeting with the Commission:

(i) Qwest's own version of the story indicates that representatives referred to Qwest's "past" IRU agreements always emphasizing they "*conveyed permanent property ownership rights in such network facilities* for the economic life of the facilities." Their version carefully indicates only that "[t]he FCC staff members present *generally* assented that such activities would be consistent with Section 271, under established precedents governing capacity IRUs."

(ii) The Touch America representative who attended the meeting denies that any such conversations occurred. Kenneth L. Williams Declaration

3. The Commission's *June 26 Merger Order*

The *Order* never refers to lit fiber capacity IRUs either generally, or in terms of the Qwest IRUs at issue here. The Commission therefore could not have approved of the IRUs.

4. Qwest's Concealment of the IRUs

Qwest went to great lengths to conceal the true nature of the IRU arrangements it planned to use post-merger. Although by its own admission Qwest contemplated entering into a lit fiber capacity IRU agreement with a potential buyer as early as February 2000, Linda Oliver Declaration, Qwest waited until mid-June 2000 to formally begin negotiations with Touch America (*i.e.*, after the time for submitting Comments on the merger had lapsed but weeks before the Commission issued its Order) and held off signing that agreement until a few days after the Commission's *June 26 Merger Order* was issued. Kevin Dennehy Affidavit. Failure to submit the lit fiber capacity IRU arrangement with Touch America violated Qwest's obligations under the *March 10 Merger Order*, which required full disclosure of the relevant arrangements between Qwest and Touch America, ¶ 25: "In addition to information on the divestiture, we expect the Applicants to be forthcoming and provide information on *any* business arrangement, beyond customer support, that would implicate a section 271 issue."

II. Qwest Has Also Unlawfully Provided In-Region InterLATA Service Through The Guise of Corporate Communications

1. Used to provide in-region interLATA "corporate communications traffic" for *un*affiliated companies such as ANR Pipeline, Star Telecom, Touch America, ICG Communications, Primus Telecommunications, Cais Internet and Electric Lightwave.

2. These services are not permissible Official Services or incidental interLATA services.

III. Qwest Has Also Unlawfully Provided In-Region InterLATA Service Directly:

1. In the most recent audit, the auditor identified 657 account records as having prohibited in-region service component codes (almost 200 more than identified in 2001), and that in-region private line services for 330 customers (almost 70 more than identified in 2001) were "billed and branded as Qwest services." March 11 2002 Arthur Andersen Audit Report, Att. 1 at 3. Qwest is still holding revenues for customer traffic that Qwest had branded, billed and collected for itself, but which rightfully belongs to Touch America.

2. The most recent 2002 audit also noted "that certain invoices during 2001 for approximately 1,000 customers who subscribe to Internet-related services did not include a separate Global Service Provider ('GSP') charge for in-region interLATA traffic carried by Touch America" (representing approximately $2 million in 2001). If true, this violates Qwest's representation concerning how it would structure the GSP arrangement in order to avoid a Section 271 violation.

IV. Qwest *Concealed* from the Commission Its Intent to Keep Touch America Dependent on It.

1. Qwest affirmatively represented in the Qwest's Divestiture Compliance Report that under that Plan "Qwest has further protected Touch America's ability to maintain a viable independent business within the region without restricting Touch America's ability to grow its business for national accounts."

2. Qwest assured the Commission that it would provide Touch America with licenses and data processing services so that "Touch America representatives will be able to utilize the existing Qwest databases to maintain accounts for existing Touch America customers, set up new accounts, obtain access to call detail records and other customer data in order to provide customer service, and engage in certain other provisioning activities" and that security precautions would be implemented "to ensure" that Qwest staff would not have access to this information. But Touch America was apparently forced to rely on Qwest for its own customers' CPNI information and for access to customer information for "Common Existing Customers." Moreover, Touch America was apparently not provided with critical reporting functionalities and/or access to four other database systems as to which Touch America was licensed and which are necessary for Touch America to adequately service the Transferred Customers.

3. Qwest assured the Commission that under the Bilateral Wholesale Agreement Touch America was not required to purchase out-of-region capacity on a wholesale basis from Qwest. But Qwest's undisclosed billing system structure apparently precluded Touch America from billing the transferred customers if it used a third party off-net provider for out-of-region capacity.

4. Qwest represented to the Commission that it would lease to Touch America four circuit switches, but this apparently did not occur. Rather, Touch America apparently was

granted only limited functionality that did not provide Touch America with the kind of operational control over the switches that would allow Touch America to perform the 'core functions' associated with the operational management of a switch. Thus, Touch America could not implement least cost routing decision and could not verify costs and revenues associated with the traffic routed through the switches.

5. Qwest forced Touch America to purchase lit fiber capacity IRUs from Qwest rather than obtaining capacity from third party carriers as Touch America had intended. Qwest also apparently forced Touch America to purchase billing and collection services from it even though Touch America sought out other vendors who offered lower rates.

V. The Commission Must Remedy these Violations.

1. Issue a Notice of Apparent Liability regarding these material violations.

2. Impose sanctions on Qwest for any and all violations of the *Qwest Merger Orders* and Section 271.

3. Open an investigation into Qwest's candor in these proceedings and impose appropriate sanctions for any Qwest misrepresentations in the merger proceedings.

PRICEWATERHOUSECOOPERS

Accounting, Auditing & SEC Developments

Issue Date: 03/21/2002
Document Title: Testimony Concerning Telecommunications Accounting Issues

Testimony Concerning Telecommunications Accounting Issues

by John M. Morrissey
Deputy Chief Accountant, U.S. Securities and Exchange Commission

Before the Subcommittee on Oversight and Investigations
Committee on Financial Services

March 21, 2002

Chairwoman Kelly, Ranking Member Gutierrez and Members of the Subcommittee:

I am pleased to appear before you on behalf of the Securities and Exchange Commission ("SEC" or "Commission") to testify concerning several accounting issues affecting the telecommunications industry. As the Subcommittee has requested, my testimony will address: 1) the accounting by providers of telecommunications capacity for the sale of an indefeasible right of use ("IRU") of such capacity, 2) the accounting for nonmonetary transactions, including "swaps," and 3) the reporting of pro-forma financial information.

Global Crossing Ltd. has disclosed that the SEC is investigating certain issues associated with Global Crossing's accounting and disclosure practices. Any further information relating to such an investigation would be nonpublic and, accordingly, my statement will be confined to the public record.1

Transparent Financial Reporting Protects the Financial Markets

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting, that is, the extent to which financial information about a company is available and understandable to investors and other market participants, plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

Transparency enables investors, creditors, and market participants to evaluate the financial condition of an entity. In addition to helping investors make better decisions, transparency increases confidence in the fairness of the markets. Further, transparency is important to corporate governance because it enables boards of directors to evaluate management's effectiveness and to take early corrective actions, when necessary, to address deterioration in the

financial condition of companies. Therefore, it is critical that all public companies provide an understandable, comprehensive and reliable portrayal of their financial condition and performance. If the information in financial reports is transparent, then investors and other users of the information are less likely to be surprised by unknown transactions or events.

Investors and creditors expect clear, reliable, consistent, comparable, and transparent reporting of events. Accounting standards provide a framework that is intended to present financial information in a way that facilitates informed judgments. For financial statements to provide the information that investors and other decision-makers require, meaningful and consistent accounting standards and comparable practices are necessary.

Recent press articles have raised questions about the transparency of the accounting and disclosure practices followed by Global Crossing. In light of these articles, I would like to review the accounting by providers of telecommunications capacity for an IRU of such capacity, the accounting for nonmonetary transactions, including "swaps," and the reporting of pro-forma financial information.

Telecommunications Capacity Purchase and Sale Agreements

The expansion of fiber optic communications increased the frequency of transactions involving the "sale" of network capacity. The granting of an indefeasible right to use such network capacity is often referred to as an "IRU." Pursuant to an IRU, an entity purchasing network capacity has the exclusive right to use a specified amount of capacity for a period of time.

Accounting by the purchaser of network capacity pursuant to an IRU has not raised significant accounting issues. An entity purchasing capacity would typically record the amount paid for the capacity as an asset,2 and amortize that asset by charges against income over the period of benefit, which would normally be the term of the capacity agreement.

For the provider of the capacity, the fundamental accounting issue related to an IRU is when to recognize revenue. That determination can be quite complex but can be boiled down to two basic questions: Is the IRU a lease or is it a service contract? And, if it is a lease, what kind of lease is it - a sales-type lease, for which revenue is recognized up-front, or an operating lease, for which revenue is recognized over time? Please allow me to elaborate on the details:

Step 1—Service contract or lease?

As I previously stated, the first step in determining when to recognize revenue is to evaluate whether the contract between the provider and purchaser of the capacity is an arrangement for the provision of a service or a lease. Although service contracts may have attributes similar to those embodied in leases, the accounting results may be dramatically different for service transactions than for leases.

Accounting for service contracts: Under generally accepted accounting principles ("GAAP"),3 revenues associated with long-term service contracts are generally recognized over time as performance occurs. The accounting guidance as to when to recognize revenue for service contracts is limited, but can be primarily attributed to the conceptual framework of the FASB and a paper published by the FASB on accounting for service contracts. The SEC staff communicated its views on various issues related to revenue recognition for service contracts in Staff Accounting Bulletin No. 101.4

Accounting for leases: FASB Statement of Financial Accounting Standards ("SFAS") No. 13, *Accounting for Leases*, and the related interpretations of this standard, provide the relevant GAAP for lease accounting, including the definition of a lease. This accounting literature defines a

lease as an agreement conveying the right to use property, plant or equipment for a period of time, and specifically excludes agreements that are contracts for **services** that do not transfer the right to use property, plant or equipment.

To the extent that a network capacity contract conveys to the purchaser the right to use specific identifiable assets5 for a period of time, providers of this capacity have concluded that such a contract meets the definition of a lease. If the network capacity contract does not convey to the purchaser the right to use specific identifiable assets, the contract would be viewed as an arrangement for the provision of services, and revenue would be recognized over the period of the contract as the services (the access to the network capacity) are provided.

Step 2—It is a lease, but what kind of lease?

For capacity contracts that meet the definition of a lease, the next significant accounting consideration is the determination of the appropriate lease classification. In a network capacity contract or arrangement that meets the definition of a lease, the capacity provider is the lessor, and the capacity purchaser is the lessee. From the lessor's perspective, there are two general types of leases - sales-type leases and operating leases.

Sales-type leases: In a sales-type lease, which gives rise to manufacturer's profit, the lessor records the fair value of the leased assets as revenue upon inception of the lease. The cost (or carrying amount) of the leased assets is charged against income in the same period that the "sale" is recognized. Sales-type lease accounting reflects in the financial statements of the lessor a sale or financing when substantially all of the benefits and risks incident to the ownership of the leased property have been transferred to the lessee.

Operating leases: Alternatively, in an operating lease, the lessor continues to record the leased assets on its balance sheet, subject to the lessor's normal depreciation policies. The minimum lease payments are recorded as rental revenue by the lessor over the lease term, typically on a straight-line basis. Operating lease accounting is similar to service contract accounting.

For a network capacity transaction to be appropriately classified and accounted for as a sales-type lease, certain specific criteria must be met. Otherwise, the transaction must be classified and accounted for as an operating lease. Further complicating the issue, these criteria differ depending on whether the leased asset is considered equipment or real estate. Under SFAS No. 13, and the related interpretations of this standard, a lease of real estate must transfer title in the leased assets to the lessee in order to be classified and accounted for as a sales-type lease by the lessor. Equipment leases need not transfer title in the leased assets to the lessor in order to be classified and accounted for as sales-type leases.

Real estate or equipment: The FASB issued Interpretation No. ("FIN") 43 in June 1999 which was effective for transactions entered into after June 30, 1999.6 FIN 43 provides interpretive guidance on the definition of real estate for accounting evaluations. This guidance, along with additional interpretive guidance provided by the FASB's Emerging Issues Task Force ("EITF"),7 has the general effect of rendering the assets subject to telecommunications capacity agreements as real estate for accounting purposes. When the interpretation in FIN 43 and the related EITF guidance became effective, many telecommunications capacity sellers concluded that they were unable to meet the title transfer requirement for the assets subject to the IRU and, therefore, were required to account for subsequent capacity sale transactions as operating leases. Prior to FIN 43, the assets subject to telecommunications capacity agreements were generally viewed as equipment, and frequently, providers of capacity accounted for these agreements as sales-type leases.

Industry Practice

In addition to these changes in the accounting rules, as the industry evolved, many capacity providers changed their service offerings to permit more flexibility than was previously available in fixed, point-to-point capacity sales. Because these more recent service offerings typically do not grant the purchaser of such services the right to use specific identifiable assets for a period of time, these arrangements fail to meet the fundamental conditions for being treated as leases, and instead are considered executory contracts (that is, contracts for the provision of services, which are specifically excluded from the lease accounting literature). Therefore, the sales-type lease accounting model may not be appropriate for more recent capacity contracts.

In administering the federal securities laws, the Commission staff has reviewed public filings of telecommunications network capacity providers and suggested that certain disclosures be made so that the accounting policies of telecommunications capacity providers are transparent to investors. In addition, the Commission staff has worked closely with the private sector accounting standards-setting organizations to identify issues related to the accounting for telecommunications capacity purchase agreements, and to resolve those issues in a manner that is in the best interests of investors. Two accounting issues have been addressed and resolved by the EITF that primarily relate to IRU accounting.8 Other issues on the EITF's current agenda could have an impact on the industry's accounting practices.9

Accounting for Nonmonetary Transactions

Several recent articles in the financial press have focused on the business practices of telecommunications companies "swapping" network capacity.10 Many of these articles suggest that the companies entering into these transactions may have inappropriately inflated their operating results by recognizing revenue for the network capacity sold, and recording long-term fixed assets for the capacity purchased. While I cannot comment on specific transactions, my testimony seeks to provide an overview of the accounting literature that addresses the accounting for exchanges of nonmonetary assets.

In general, GAAP requires that the accounting for the exchange of nonmonetary assets be based on the fair value of the asset received or given up, whichever is more reliably determinable.11 One of the exceptions to this general principle is an asset exchange that does not represent the culmination of the earnings process. For example, an exchange of an asset held for sale in the ordinary course of business (such as inventory) for an asset to be sold in the same line of business. Furthermore, the exchange of a productive asset not held for sale for a similar productive asset also is not viewed as the culmination of the earnings process. These types of nonmonetary exchange transactions are required to be accounted for based upon the recorded amount, or book value, of the asset relinquished.

The simultaneous exchange of nonmonetary assets along with equal amounts of cash consideration between the parties to an exchange would raise significant "substance" over "form" questions. When cash consideration is exchanged between the parties to a transaction concurrently with an asset exchange, questions may arise as to the substance or business purpose of the transaction structure, and whether that structure has an economic purpose or is designed solely to remove the transaction from the scope of the accounting literature governing nonmonetary asset exchanges.

In these situations, a careful analysis of the specific facts and circumstances surrounding the transaction would have to be made. To the extent that the "check swapping" between the parties lacks economic substance, such a practice should not alter the accounting for such exchange transactions. In other words, the accounting rules for nonmonetary asset exchanges should be followed. These rules require that certain conditions be met in order for the transaction to be accounted for at fair value.

In order to conclude that a network capacity swap transaction should appropriately be accounted for as revenue and a capital expenditure at fair value, a company entering into such a transaction would have to reach the conclusion that: 1) the network capacity received in the exchange will not be sold in the same line of business as the network capacity given up in the exchange, 2) the network capacity received in the exchange is a productive asset that is dissimilar to the network capacity given up, and 3) the fair values of the assets exchanged are determinable within reasonable limits. Capacity swap transactions likely include complex terms that would require a diligent analysis and professional judgment to determine the proper accounting treatment.

Companies that engage in material nonmonetary transactions during a reporting period are required, under GAAP, to disclose, in the footnotes to the financial statements, the nature of the transactions, the basis of accounting for the assets transferred (that is, fair value or book value), and gains or losses recognized. GAAP also requires that information about all investing and financing activities of an enterprise that affect recognized assets or liabilities but that do not result in cash receipts or payments, such as nonmonetary asset exchanges, be disclosed in the footnotes to the financial statements.

Furthermore, the Commission's rules require registrants to include in their public filings a section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").12 In MD&A, registrants are required to discuss the known trends, demands, events, commitments and uncertainties that are reasonably likely to materially affect a registrant's liquidity, capital resources, and results of operations. To the extent that nonmonetary exchange transactions have a significant impact on a registrant's liquidity, capital resources, or results of operations, disclosure of these transactions in MD&A would be required.

Pro-forma Financial Information

Recent press articles have also focused on Global Crossing's use of "pro forma" financial information in its earnings releases. "Pro forma," in this context, generally refers to the presentation of earnings and results of operations on the basis of methodologies other than GAAP.

"Pro forma" financial information can serve useful purposes. Public companies may quite appropriately wish to focus investors' attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations. There is no federal securities law prohibition preventing public companies from publishing interpretations of their financial results or publishing summaries of GAAP financial statements.

Nonetheless, the Commission is concerned that "pro forma" financial information, under certain circumstances, can mislead investors if it obscures GAAP results. Because this "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.

The Commission has cautioned companies and alerted investors to the potential uncertainties of "pro forma" financial information. Most recently, on December 4, 2001, the Commission issued cautionary advice that companies and their advisors should consider when releasing "pro forma" financial information.13 Among other things, this release reminded companies and their advisers that:

First, the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. Because "pro forma" information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be

particularly mindful of their obligation not to mislead investors when using this information. Recently, the Commission concluded its first pro forma financial reporting case ever, regarding the issuance of a misleading earnings release by the Trump Hotel and Casino Resorts, Inc.14 This action demonstrated the Commission's commitment to address the dangers of "pro forma" financials.

Second, a presentation of financial results that is addressed to a limited feature of a company's overall financial results (for example, earnings before interest, taxes, depreciation, and amortization), or that sets forth calculations of financial results on a basis other than GAAP, raises particular concerns. Such a statement misleads investors when the company does not clearly disclose the basis of its presentation. Investors cannot understand, much less compare, this "pro forma" financial information without an indication of the principles that underlie its presentation. To inform investors fully, companies need to describe accurately the controlling principles. For example, when a company purports to announce earnings before "unusual or nonrecurring transactions," it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.

Third, companies must pay attention to the materiality of the information that is omitted from a "pro forma" presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information. For example, investors are likely to be deceived if a company uses a "pro forma" presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.

Fourth, public companies should consider and follow the recommendations regarding pro forma earnings releases jointly developed by the Financial Executives International and the National Investors Relations Institute before determining whether to issue "pro forma" results, and before deciding how to structure a proposed "pro forma" statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

With appropriate disclosure, accurate interpretations and summaries of GAAP financial statements benefit investors. Our cautionary advice is part of our ongoing commitment to improve the quality, timeliness, and accessibility of publicly available financial information. At the same time, the Commission is focusing on ways in which our current periodic reporting and disclosure system can be updated to fill the void that "pro forma" statements may be attempting to fill.15

Conclusion

Many of the accounting issues surrounding the accounting for telecommunications capacity contracts are complex, and I have provided only a brief summary of some of the more significant issues. We very much appreciate your prompt action and interest in the current issues that impact financial reporting and our capital markets. You can be assured that the SEC staff takes very seriously allegations of financial reporting improprieties by public companies. Furthermore, in our oversight capacity, the SEC staff will continue to monitor developments in the accounting practices of the telecommunications industry, and provide recommendations for issues that need to be addressed by the accounting standards-setting organizations.

Endnotes

1 The information contained in this statement concerning Global Crossing's accounting practices is based upon publicly available information.

2 Depending on the nature of the capacity purchase agreement, the purchaser would possibly record either a fixed asset, such as property, plant, and equipment, or a prepaid expense.

3 While the Commission has the statutory authority to set accounting principles, for over 60 years it has looked to the private sector for leadership in establishing and improving accounting standards. The quality of our accounting standards can be attributed in large part to the private sector standards-setting process, as overseen by the SEC. The primary private sector standards-setter is the Financial Accounting Standards Board ("FASB").

4 See Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, December 3, 1999.

5 For example, a specific fiber or wavelength of light within a fiber-optic cable network, along with the conduit through which that cable passes, the land on which the conduit rests, and a specific component of the telecommunications equipment at each end of the cable necessary to transmit data over the network, would represent specific identifiable assets.

6 See FIN 43, *Real Estate Sales, an Interpretation of FASB Statement No. 66.*

7 See EITF Issue No. 00-11, *Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13*, and EITF Issue No. 00-13, *Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98.*

8 See footnote 7.

9 See EITF Issue No. 01-08, *Determining Whether an Arrangement is a Lease*, EITF Issue No. 01-04, *Accounting for Sales of Fractional Interests in Equipment*, and EITF Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables.*

10 See, for example, "Optical Illusion? Accounting Questions Swirl Around Pioneer In the Telecom World," *The Wall Street Journal*, February 13, 2002, and, "Losing a Grip on the Fiber Optic Swap," *The New York Times*, February 18, 2002.

11 Accounting Principles Board (the predecessor to FASB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, provides relevant guidance on the accounting for these types of transactions.

12 See Regulation S-K, 17 CFR, Item 303.

13 See Financial Reporting Release No. 59.

14 See Accounting and Auditing Enforcement Release No. 1499.

15 See Testimony of Harvey L. Pitt, Chairman of the U.S. Securities and Exchange Commission, Concerning H.R. 3763, the "Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002," Before the House Committee on Financial Services (March 20, 2002), explaining the Commission's disclosure initiatives.

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A PricewaterhouseCoopers Special Report

Ventures on the High Seas
U.S. Federal tax treatment of a sale of IRU capacity

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As international demand for data and voice communications grows, the business of building and operating transoceanic telecommunications cables is burgeoning, with investment in undersea fiber deployment expected to top US$27.5 billion over the next four years. In this article, one in a series regarding the issues entailed in this complex and increasingly competitive business, we examine key U.S. tax issues encountered by sellers and purchasers of indefeasible rights of use (IRUs), the chief means for selling capacity on transoceanic cables.

Transoceanic cables, once the domain of consortia of national telecommunications companies, are now being built and marketed by an array of telcos. The global trend to deregulate telecom, combined with unprecedented demand for transmission capacity, has resulted in a dramatic increase in construction of transoceanic cables. Demand for both transatlantic and transpacific capacity is doubling annually, driven to a large extent by the Internet and increased transmission of data traffic.

Capacity on these cables, once divided on a cost-sharing basis between national telcos, is now commonly marketed through indefeasible rights of use (IRUs). In most commercial arrangements, purchasers of IRUs bear the risk of failure of the cable and assist in financing construction by making advance payment before construction begins. The company that develops the cable and grants the IRUs maintains legal title to and control over the assets.

This paper considers the U.S. federal income tax treatment of a sale of IRU capacity on a telecommunications cable, with particular emphasis on transoceanic cables. There are three possible characterizations of a sale of an IRU over a transoceanic fiber optic cable—a sale of property, a lease of property, or a sale of service—each of which has been used by various players in certain circumstances,

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to both good and ill effect. The difficulty in analyzing the appropriate tax treatment is in the fact that an IRU does not easily fit the definition of any of the three.

- When an IRU is granted, no proprietary interest changes hands, so a sale of an IRU is not purely analogous to the *sale of property*.
- An IRU is not exactly like a *lease* because the holder does not acquire exclusive rights to the transoceanic cable.
- Because the grantee typically receives no refund of the cost of the IRU if the cable ceases to function, an IRU does not exactly resemble a *service* either.

Further, the transmission of data along the cable is virtually instantaneous and completely automated, and therefore does not actually rely on the actions of either party.

Because the tax treatment of the sale of an IRU can vary greatly depending on how the transaction is structured, tax planning should always be part of drafting an IRU agreement. Some have used the differences in characterization to their advantage, while others have fallen into hidden tax traps. To avoid these, various factors go into determining how IRUs should be characterized.

Characterizing the sale of IRUs

IRUs are created contractually, rather than through legislation or regulation. Therefore, each IRU (even for capacity on the same cable) can be unique. However, most IRU arrangements have certain features in common. For the purpose of simplicity in our analysis, we will assume that IRUs are generally structured as follows:

- The purchaser receives a right to use an assigned amount of capacity on a telecommunications cable in exchange for payment or payments before or on the date the cable is first ready for service.
- No proprietary interest in the physical cable or its underlying assets is transferred to the purchaser.
- The purchaser bears the risk of malfunction or failure of the cable during the term of the IRU.
- The purchaser is responsible for the operation and maintenance costs incurred during the term of the IRU.

Two related factors are very important in characterizing the transfer of an IRU interest: the period for which the IRU is granted and the estimated economic useful life of the underlying cable. Generally, when an IRU is granted for substantially the entire economic useful life of the cable, the probable (although not definite) result is that the granting of the IRU is a *sale* of the underlying cable and associated assets. However, when an IRU is granted for a period that is significantly less than the economic useful life of the cable, the IRU is more properly characterized as a *lease* or the *provision of a service*.

Although it is generally assumed within the industry that a cable constructed today will have an economic useful life of 10 to 15 years, it is impossible to be certain how long a cable will be used. If the cost of transmitting data continues to decrease at its current rate, purchasing capacity on a new cable could become more economical than paying the operation and maintenance fees charged for use of a cable that is 5 or 10 years old. In this case, the economic useful life of the existing cable would arguably end at this

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point because the fair market value of the cable would be close to $0. For tax purposes, however, the critical factor is the estimated life at the time of the IRU purchase.

States vary in their treatment of IRUs - some following the federal determination and some don't; some even treat the IRU one way for income tax purposes and a different way for other taxes, such as property tax or sales and use taxes.

To analyze the tax treatment for IRUs, we considered the following questions:

Is the sale of an IRU a sale of the underlying property?

For U.S. federal tax purposes, the determination of whether it is a sale depends on:

- The length of the IRU.
- The terms of any periodic operation and maintenance (O&M) payments that will be passed through to the IRU holder.
- The other benefits and burdens of ownership that indicate who is considered the owner of property for federal tax purposes, including (1) whether it can be transferred, (2) who bears the risk of loss and damage, (3) who retains the residual value (the economic upside), (4) who has possession and control, and (5) how the parties treat the transaction.

States vary in their treatment of IRUs—some following the federal determination and some don't; some even treat the IRU one way for income tax purposes and a different way for other taxes, such as property tax or sales and use taxes.

There is no clear federal authority on the tax treatment of income derived from the granting of an IRU for property for a period greater than the economic useful life of that property. General principles therefore determine how to characterize the income. Tax authorities generally disregard the form or label of a transaction if it is inconsistent with the economic substance of the transaction.

Whether the assets underlying an IRU are considered sold to the purchaser for tax purposes depends on whether the economic owner of the property is the purchaser or seller of the IRU. Thus, it is necessary to determine which is the economic owner. It is not unusual for one entity to hold bare legal title for regulatory or commercial purposes while another entity has the true economic ownership of property. The relative benefits and burdens of ownership have previously been used to designate the economic owner of an asset.[1] The benefits of ownership include the absolute right to negotiate or arrange for the disposition of the asset and the right to realize appreciation in the market value of the asset. The burdens include the risk of loss, the risk of the legal liability arising from the use of the property, and the risk of non-performance of various obligations.[2] Thus, again, not all IRUs can be characterized the same way. The Supreme Court put forth a standard—the economic substance test—and stepped away from the strict balancing of benefits and burdens. The economic substance test holds that, when there is a genuine transaction with economic substance, rather than one shaped solely to achieve tax avoidance with

[1] *Helvering v. Lazarus*, 308 U.S. 252 (1939); *Sun Oil Co. v Commissioner*, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1977).
[2] In *Frank Lyon Co. v. U.S.*, 435 U.S. 561 1978 and *Hilton v. Commissioner*, 74 T.C. 305, 346 (1980).

meaningless labels attached, the allocation of rights and duties by the parties should be respected. Later court decisions condensed the economic substance test by restating the inquiry as whether the transaction has any practical economic effects.[3]

One federal ruling did consider IRUs but assumed without comment that the IRU purchaser "owns" a portion of the cable.[4] The Federal Communications Commission (FCC) also seems to consider an IRU purchaser to be an owner of the cable.[5] In 1983, the FCC, in considering whether private carriers should be permitted to purchase IRUs, found that "a policy allowing non-carrier IRUs would alter those current customer/carrier relations by opening a new class of ownership and operation. If enhanced-service providers avail themselves of such a policy, they will be transformed from users to owners of facilities."

As mentioned above, a key determinant in IRU sale characterization is the duration of the IRU. Under general federal principles, if the IRU will last for a period equal to or greater than the estimated economic life of the cable, the purchaser is considered to have most of the rewards of ownership. One potential reward such a purchaser does not have is the resale value of the underlying assets upon termination of the IRU. As discussed above, however, after a few years, this value is probably quite low. Thus, from an economic-substance viewpoint, the purchaser is likely to be the owner of the property for tax purposes.

One additional potential reward that does not inure to the purchaser is the value of enhanced transmission capacity on a cable. IRUs are granted for an assigned amount of capacity (in megabits per second) rather than a percentage of total capacity on a cable. Although the capacity on a cable may be fully subscribed when first placed in service, with subsequent technical enhancement, additional capacity could later be created and sold by the original grantor of the IRU to both existing and new IRU holders. This possibility is fundamentally at odds with the view that the telco granting IRUs is simply selling the underlying asset (the cable) to the purchasers, and this could result in characterization as a lease or service agreement.

Is the sale of an IRU a lease or a sale of services?

If the term of the IRU, or other factors, indicate that it is not a sale of the underlying property, then it is either a lease of the property or a sale of services. The distinction between a lease of property and a sale of services is dealt with in Internal Revenue Code (IRC) §7701(e) and the underlying regulations.

Essentially, the economic substance of the IRU agreement determines whether the agreement is a contract for services or a lease of property. A contract for services can be characterized as a lease for income tax purposes. The factors relevant to such a reclassification include:

1. Physical possession
2. Control of the property
3. Economic or possessory interest
4. Substantial risk of nonperformance
5. Concurrent use of the property
6. Contract price
7. Other relevant facts and circumstances

No one factor determines the proper characterization. Also, the same fact may support the presence or absence of more than one of these criteria. Based on the factors described below, it appears that a typical long-term IRU that is not treated as a sale of the underlying assets would be considered a lease rather

[3] Sacks v. Commissioner, 69F.3d 982 (9th Cir. 1996) revg. 64T.C.M. 1003 (1992).
[4] GCM 36334 (July 2, 1975).
[5] In the Matter of International Communications Policies Governing Designation of Recognized Private Operating Agencies, Grants of IRUs in International Facilities and Assignment of Date Network Identification Codes, 96F.C.C.3d 627 (1983).

than a service contract. However, it is necessary to consider the facts of any particular IRU before determining whether lease or services characterization is more appropriate.

1. Physical possession

Physical possession of the property by the service recipient is indicative of a lease. A service recipient has physical possession of property if that property is located on the recipient's premises or located off the premises but operated by the recipient's employees. The service provider also has physical possession of the property if it retains sufficient control of the property even when the property is located at the service recipient's premises.[6]

An IRU that conveys to the service recipient only a right to use an assigned amount of capacity in the transoceanic cable will not convey physical possession to the service recipient. However, if the cable station is on the premises of the service recipient, this initial conclusion may require revision.

No one factor determines the proper characterization. Also, the same fact may support the presence or absence of more than one of the above criteria.

2. Control of the property

If the service recipient takes control of the property, this is indicative of a lease. "Control of the property" refers to control over its operation, maintenance, or improvement. Contractual provisions that enable the service recipient to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards do not constitute control.[7]

The question of which entity, if any, "operates" a transoceanic cable is difficult to determine. A transoceanic fiber optic cable is an automated piece of equipment capable of near-instantaneous transmission of data. Therefore, it seems logical to impute operation to the equipment that connects to and controls the cable (i.e., the cable terminal equipment). By this test, if the service provider is responsible for maintenance, replacement, and repair, the service provider controls the property.

3. Economic or possessory interest

A contract that conveys a significant economic or possessory interest to the service recipient resembles a lease.[8] Economic or possessory interest may be established by showing that:

- The property's use is likely to be dedicated to the service recipient for a substantial portion of its useful life.
- The recipient shares the risk that the property will decline in value or will share the benefit of any appreciation of its value.

[6] *Xerox Corp. v. U.S.*, 656 F.2nd 659, 676 (Ct. Cl. 1981).
[7] General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, Cong. Jt. Comm. On Tax, 98th Cong., 2d Sess. "Bluebook", p. 59.
[8] Bluebook, p. 60.

- The recipient shares in savings in the property's operating cost.
- The recipient bears the risk of damage to or loss of the property.

In private letter rulings, the IRS has indicated that a 70% interest constitutes a substantial portion of a property's useful life, whereas a 58% or 40% interest does not.[9]

4. Substantial risk of nonperformance

Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract by the service provider or by the property involved.[10] Fixed payments based on the passage of time, such as a monthly lease payment (as opposed to payments based on the quantity or quality of the actual services rendered), support a lease characterization.[11]

An IRU generally is granted for an assigned amount of available capacity for a specified time period. Typically, no refund is available in the event of cable malfunction, and the IRU purchaser pays for any repair and maintenance costs. In such a situation, the service recipient carries the risk, as though in a lease.

5. Concurrent use of the property

Evidence that the service contract does not restrict the service provider from utilizing the underlying assets to provide significant services to entities unrelated to the service recipient would support a holding that the contract is for services.

Generally, IRUs in a cable network are granted to multiple users. This suggests that an IRU is a service contract.

6. Contract price

A total contract price (including expenses to be reimbursed by the service recipient) that substantially exceeds the rental value of the property for the contract period is indicative of a service contract.[12] Conversely, the fact that the total contract price is based principally on the recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for the use of the property is indicative of a lease.

O&M fees are generally charged in addition to the cost of obtaining an IRU. This suggests that an IRU can be considered a lease.

[9] PLR 8718016, PLR 8142022, and PLR 8918012, respectively.
[10] (Bluebook, p. 60).
[11] Rev. Rul. 72-407; Rev. Rul. 71-397.
[12] Bluebook, p. 60; PLR 8718016.

7. Other relevant factors and circumstances

In considering whether an agreement that purports to be a service contract should be treated as a lease, IRC §7701(e)(1) requires an examination of all the relevant facts and circumstances of a case. Official authorization was considered important in various letter rulings. For example, the fact that the business was governed by tariffs on file with the FCC, which did not authorize sales or leases, supported the contention that the agreement was a service contract.[13] On the other hand, property that is built to a customer's specifications is likely to be considered leased to the customer.[14]

Assuming the sale of an IRU is the sale of the underlying property, does FIRPTA apply?

Section 897 of the IRC (enacted by the Foreign Investment in Real Property Act of 1980 (FIRPTA)), taxes foreign investors on disposition of investments in U.S. real property. The purchaser is required to withhold 10% of the purchase price on the disposition by foreign corporations of interests in real property and interests in domestic or foreign corporations that qualify as U.S. real-property holding corporations.[15] If a foreign person sells an IRU to a U.S. taxpayer, the transaction must be analyzed to determine whether FIRPTA applies.

When an IRU is purchased from a foreign seller, the question is whether any portion of the cable consists of FIRPTA property. The cable, terminal equipment, and landing station should all be considered separately. Section 897 provides some guidance on this issue, but the answer is not entirely clear and depends to some extent on the technical specifications of the cable and equipment at issue. Some states, such as California, have provisions analogous to FIRPTA.

Real property includes:

1. Land and unsevered natural resources on the land (e.g., mines, wells, and other natural deposits).
2. Improvements (such as a building or any other inherently permanent structure).
3. Personal property associated with the use of real property (such as movable walls and furnishings).[16]

A brief review of the regulations demonstrates that submarine cables, terminal equipment, and landing stations do not fall within either category 1 or category 3.[17] Category 1 includes "land growing crops and timber, and mines, wells, and other natural deposits."[18] Category 3 includes personal property associated with the use of real property only if it is described in subdivisions A through D of Treasury Regulation §1.897-1(4).

Subdivision A describes property used in mining, farming, and forestry. Subdivision B describes property used in the improvement of real property in this way: "Personal property is associated with the use of real property if it is predominantly used to construct or otherwise carry out improvements to real property. Such property includes equipment used to alter the natural contours of the land, equipment used to clear and prepare raw land for constructions, and equipment used to carry out the construction of improvements." Subdivision C describes property used in the operation of a lodging facility. Finally, subdivision D describes property used by a lessor to provide furnished office or other workspace to lessees.

[13] (Rev. Rul. 68-109, 71-397; Rev. Rul. 72-407).
[14] (Bluebook, p. 60).
[15] IRC §897(c)(1)(A)(i) and (ii).
[16] Treas. Reg. §1.897-1(b).
[17] Treas. Reg. §1.897-1(b)(2) and (4).
[18] Treas. Reg. §1.897-1(b)(2).

Therefore, the only issue seems to be whether submarine cables, landing stations, or terminal equipment fall within category 2, improvements. Treasury Regulation §1.897-1(b)(3) provides that, "An improvement is a building, any other inherently permanent structure, or the structural components of either."

Landing stations as FIRPTA property

Generally, a landing station is considered a building or an inherently permanent structure. Accordingly, landing stations are real property.

Treasury Regulation §1.897-1(b)(3) defines a building as "any structure or edifice enclosing a space within walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing or to provide working, office, parking, display, or sales space." The regulation lists as examples apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores.[19]

As the definition of a building is identical in Treasury Regulation §1.48, the commentary under that regulation is helpful. For purposes of Treasury Regulation §1.48-1(e)(1), a structure constitutes a building if [1] it resembles a building and [2] it functions as a building. (See also footnote 19). The resemblance test comes from the part of the regulation that states that a building "generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof...." (See also footnote 19.)

Similar to the resemblance test is the function test, by which a structure is considered a building if its purpose is "to provide shelter or housing, or to provide working, office, parking, display, or sales space."[20] The IRS considers a structure to be a building even if the activity it shelters is performed only by machines.[21] A similar position was taken by the 8th U.S. Circuit Court,[22] which held that "a structure functions as a 'building' if it provides shelter for significant machine or animal activity or if it provides working space for humans."[23] Based on the above, landing stations should be treated as buildings because they shelter terminal equipment and resemble buildings.

Even if a landing station is not a building, it can still be real property if it is an inherently permanent structure. Treasury Regulation §1.897-1(b)(3)(iii) provides that an inherently permanent structure is "any property not otherwise described in this paragraph (b)(3) that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time. . . . For purposes of this section, affixation to real property may be accomplished by weight alone." Thus, because a landing station is a structure that rests on land, it should be treated as an inherently permanent structure. Accordingly, a landing station, even if it is not a "building," should be treated as real property.

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[19] Treas. Reg. § 1.897-1(b)(3). Treasury Regulation §1.48-1(e)(1), which addresses what property is eligible for the "Section 38" investment tax credit, defines "building" in the same way and cites the same examples. Treasury Regulation § 1.48, however, goes on to state that the term "building" does not include:

> (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) [such as manufacturing, production, communications] if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced.

[20] Id. (quoting Treas. Reg. Sec. 1.48-1(e)(1)).

[21] Technical Advice Memorandum 8018013 (1980).

[22] *L&B Corporation v. Comm'r.*, 862 F.2d 667 (8th Cir. 1988).

[23] 862 F.2d at 672 (citing Starr Farms, Inc. v. U.S., 447 F. Supp. 580 (W.D. Ark. 1977): "[A] structure will be deemed to function as a building even if the activity which it shelters is performed solely by machine or animal".

Terminal equipment as FIRPTA property

Obviously, terminal equipment is not a building. Nor is the terminal equipment analogous to any of the examples of inherently permanent structures provided in the regulations. Treasury Regulation §1.897-1(b)(3) provides that property that is essentially an item of machinery or equipment under Treasury Regulation §1.48-1(c) or 1.48-1(e)(1)(i) will not be treated as an inherently permanent structure.

Submarine cables as FIRPTA property

Permanently installed telephone cables are listed in Treasury Regulation §1.897-1(b)(3)(iii)(B) as an example of an inherently permanent structure. Intuitively, submarine cables are correctly viewed as permanently installed, because (1) when they are no longer used, submarine cables are abandoned; and (2) in shallow water, submarine cables are buried under the ocean floor. Generally, a cable farther than about 1,000 feet offshore rests on the ocean floor and is moved only when a repair is required.

Even if the phrase "permanently installed telephone or television cables" was intended to describe cables installed in buildings, the Treasury regulation suggests that a submarine cable should be treated as an inherently permanent structure unless it is found to be machinery or equipment.[24]

In summary, landing stations are either buildings or inherently permanent structures and should be treated as real property. Although there is room to argue to the contrary, submarine cables should be treated as inherently permanent structures and thus real property. Terminal equipment, on the other hand, is not an inherently permanent structure and should not be treated as real property.

The extent to which the cable is U.S. property (i.e., physically in the United States) also needs to be considered. Possibilities here would include property within 3, 12, and 200 miles from U.S. land. The 12-mile limit appears to be the generally accepted standard within the cable industry.

Subpart F income

Assuming the sale of an IRU is the sale of the underlying property from a controlled foreign corporation, will Subpart F impute income from the sale to its U.S. parent?

A sale of an IRU can also give rise to Subpart F income. Subpart F income includes "foreign-base shipping company income," which includes income derived from a space or ocean activity under IRC §863(d)(2). Ocean activity is defined to include any activity conducted on or under water not within the jurisdiction of a foreign country, but not income giving rise to international communications income (ICI).

Thus, the sale of the IRU will be Subpart F income if the sale results in income from ocean and space activity. Assuming the sale of an IRU constitutes the sale of property, income received from the sale is likely not derived from any activity, or at least any activity conducted on or under water. However, to the extent that the income is derived from an activity that takes place under water, as with the transmission of communications, there may be sufficient activity to qualify it as resulting from ocean and space activity.

Further, to the extent that the sale is of real property (FIRPTA would not apply otherwise), whether it may also be brought into the Subpart F regime as foreign-base company sales income should also be analyzed.

Does the sale of an IRU produce international communications income?

[24] Treas. Reg. §1.897-1(b)(3)(iii) provides that the "term 'inherently permanent structure' means any property not otherwise described in this paragraph (b)(3) that is affixed to real property and that will ordinarily mean affixed for an indefinite period of time."

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As stated above, if the income from the sale of the IRU is properly characterized as ICI, then it will not be characterized as ocean activity. ICI includes all income derived from the transmission of communications or data to or from the U.S. The proceeds from the sale of an IRU are received in exchange for the granting of a right to use capacity on a transoceanic cable. The vendor receives income in exchange for granting capacity on the cable, not for transmitting data. In fact, the amount of data the purchaser actually transmits over the cable is not relevant to the payment for the IRU. Accordingly, income from the sale of an IRU will probably not be characterized as income from the transmission of communications or data and should not be considered ICI.

Permanent establishment / U.S. trade or business

Two standards exist for determining whether a foreign corporation has a sufficient connection to or presence in the United States to be subject to U.S. taxation: whether the corporation is engaged in a U.S. trade or business, a concept that is contained in the Internal Revenue Code, and which applies to foreign corporations that are not eligible for the benefits of an international income tax treaty; and (2) whether the corporation is a permanent establishment, a standard contained in international income tax treaties.

In general, the permanent establishment standard requires that, to be taxable in the United States, a foreign corporation would have to have a fixed place of business through which its business is wholly or partly carried on. Once such a permanent establishment is found, then the business profits attributable to the permanent establishment can be taxed.

With the "engaged in a U.S. trade or business" standard, the foreign corporation need not have a fixed place of business in order to be taxable on its U.S. source income derived by the U.S. trade or business. The foreign corporation, however, must have an office or fixed place of business in the U.S. for the foreign-source income of the U.S. trade or business to be subject to tax in the U.S.

Although the guidance available on what constitutes an office or fixed place of business was drafted with regard to the sale of goods, it also contains two relevant points for the provision of telecommunications services. According to Treas. Reg. §1.864-7(a)(2), particular consideration should be given to (1) the nature of the taxpayer's trade or business, and (2) the physical facilities actually required by the taxpayer in the conduct of his trade or business. Thus, it is possible that a business, such as telecommunications services, which can be conducted via equipment and cable facilities, rather than an office staffed with people, may still be taxable. The phrase "U.S. trade or business" is not defined by the Internal Revenue Code. However, court decisions have held that a taxpayer must have "considerable, regular, continuous" activity within the United States to be engaged in a U.S. trade or business.

A permanent establishment in most tax treaties is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." Permanent establishment includes, especially, a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources.[25] In addition, some treaties (for example, the U.S. treaties with Israel, Morocco, and Norway) provide that the maintenance of substantial equipment in the other country constitutes a permanent establishment.

In the context of telecommunications, a Department of Treasury policy statement makes a distinction between persons for whom the use of telecommunications equipment is incidental to their business and those for whom the use of the telecommunications equipment is integral to the provision of telecommunications services:

[25] (Arts. 5(1) – (2), U.S. Model Treaty).

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> The principles used to determine whether a person is engaged in a U.S. trade or business or maintains a U.S. permanent establishment might differ if the person is primarily engaged in providing telecommunications services, in contrast to a business which is primarily engaged in selling goods or services for whom the telecommunications services are merely incidental. A distinction is generally recognized between activities that contribute to the productivity of the enterprise and activities that involve the actual realization of profits. In the case of a foreign telecommunications provider, the operation of a computer server in the United States or the sale of computing services and Internet access to U.S. and foreign customers is clearly integral to the realization of its profits, in contrast to the case of a foreign person who is primarily engaged in selling data which is stored on a U.S.-based server.[26]

The Organization of Economic Cooperation and Development's (OECD's) commentary on the permanent establishment provisions of its model income tax treaty examines the possibility that automatic equipment can constitute a permanent establishment:

> A permanent establishment may nevertheless exist if the business enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to the setting up, operating, controlling, and maintaining of such equipment. Whether or not gaming or vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise that sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise. (Commentary to OECD Model Tax Convention, Art. 5, Para 10).

At least one court interpretation includes unmanned equipment in the permanent establishment standard. The case involved an oil pipeline that ran between two points in the Netherlands, yet crossed a portion of Germany. The Dutch company had no employees in Germany, and all technical and marketing people were situated in the Netherlands. The court nonetheless held that the Dutch company had a permanent establishment in Germany by virtue of its pipeline's presence there. In summary, there is no controlling authority on whether the mere ownership of telecommunications assets will create a taxable presence in a particular country. However, considering the potential tax impact such a finding would have, it is critical that telecommunications companies consider this issue carefully, and take whatever practical measures they can to minimize this risk.

[26] Dept. of the Treasury, Office of Tax Policy, Selected Tax Policy Implications of Global Electronic Commerce, Para. 7.2.6, November 1996.

Following deregulation and increased international competition, a new model has evolved. A local-country operating company no longer needs to own a cable interest on a notional half circuit.

U.S. property-owning company

What are the advantages to having a separate company own the U.S. assets?

Transoceanic cables have historically been divided at the "hypothetical midpoint" in the ocean, a concept developed when most countries had one government-sponsored telecommunications company. Thus, for example, AT&T would own one-half of a transatlantic cable, and British Telecom would own the other half. Each company would own the "notional half circuit" from its country to the middle of the ocean.

Following deregulation and increased international competition, a new model has evolved. A local-country operating company no longer needs to own a cable interest on a notional half circuit. Instead, it is often advantageous for such a company to own only the portion of the cable and associated equipment that are located inside the taxing jurisdiction of that country. A separate related company in a lower-tax jurisdiction would own the property considered to be in international waters. Since transfer pricing between related telecom companies is often based, at least in part, on the value of assets owned, this serves to reduce the tax burden of the local operating company and the overall effective tax rate of the company.

State tax issues to be considered

The character of the transfer of an IRU is also important for state tax purposes. Depending on its character, the transaction may give rise to both income tax and transaction tax burdens on the parties in any given state. Local taxes must also be considered. The laws of each state must be analyzed to determine the following:

- Does the state have sufficient nexus (minimum contract) with either the transferor or the transferee of the IRU to impose state taxes as a result of the transaction?
- If the state has nexus, what state taxes will apply? Taxes that should be analyzed for applicability include:
  - Income and/or gross receipts-based taxes
  - Transaction taxes, including sales/use and excise taxes
  - Property tax

Conclusion

Generally, an IRU granted for the economic useful life of a transoceanic cable should be treated as the sale of property for U.S. federal income tax purposes. However, as the market for transmission capacity continues to grow and mature, this issue and the others discussed above should be further refined. Characteristics of an IRU may change. Accordingly, it is necessary when first considering the federal tax treatment of an IRU to understand the conceptual basis of the proposed treatment and to look carefully at what is being provided and received.

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